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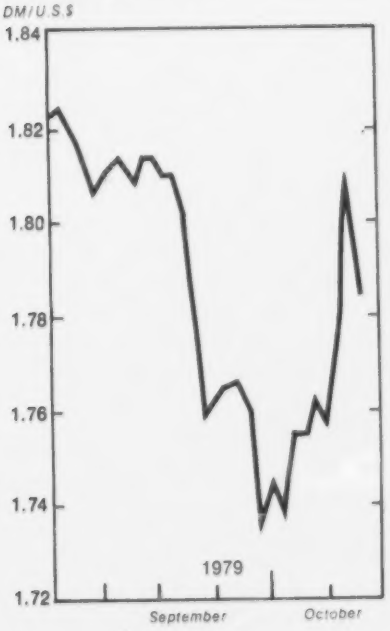
The Fed's Surprise Package

The timing of the Federal Reserve Board's dollar-relief package was hardly a surprise, but the contents were. The market expected something of a replay of the events of last November—coordinated intervention with enlarged central-bank swaps lines, additional sales of foreign-currency-denominated U.S. Treasury liabilities, and another upward ratchet in the discount and Federal funds rates. And in the United States, at least, the increase in domestic short-term interest rates was expected to be modest. The package actually announced was much more powerful—a one-percentage-point discount rate hike with a promise of more to come if use of the discount window increases; relatively stiff marginal reserve requirements on so-called "managed bank liabilities"; and the announcement of a shift in the Fed's operational tactics from control of short-term interest rates to management of bank reserves. Moreover, the Treasury option of issuing additional DM-denominated debt remains to be exercised.

The dollar's DM exchange value



The reaction of the foreign-exchange markets has been favorable up to now. Although a hard core of suspicion remains that the new-found U.S. resolve to control inflation will weaken in the course of an election year, Chairman Volcker seems to have made his point. By designing a surprise package that suggests both long-term and short-term objectives, the Fed has forced the market to reconsider its expectations concerning future U.S. inflation. The one-sided and potentially disorderly market conditions of two weeks ago have been replaced by a two-sided uncertainty about the future course of the dollar.

Two further points need underscoring. First, although the tenor of the foreign-exchange and commodities markets determined the timing of the policy move, the substance of the package is at least as much oriented to domestic as well as external objectives. The jury is still out on the question of whether foreign considerations will be given significantly greater weight in the formulation of U.S. monetary policy by the Volcker Board. Second, the announced shift in the Fed's tactics of monetary control toward management of the monetary base should not be interpreted as a shift toward "monetarism." Indeed, if there is a doctrinal implication of the move, it is that doctrine is being abandoned. The Board is saying that the monetary aggregates need to be brought under stricter control, and that is hardly a uniquely monetarist conclusion.

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Massive U.K. wage demands weaken sterling.

The start of the annual round of wage negotiations in the United Kingdom has created some uncertainty in foreign-exchange markets. From an exchange value of $2.26 and DM 4.14 at end-July, sterling began to fall and show wide daily fluctuations; as of the end of September its value had dropped to $2.20 (against a weak dollar) and DM 3.84. While the round was launched with the usual massive wage demands, actual settlements are expected to be significantly less. Last year's round, for example, opened with wage claims exceeding 30%, but total earnings rose by only 14% over the year. A similar pattern is expected for this year; indeed, the Government's tight monetary stance now threatens workers with the stark choice between jobs and wages. Even at current levels, sterling is sufficiently strong to create problems for exports, while high interest rates and rising prices threaten a marked slowdown in both investment and consumer demand—all of which could lead to almost no growth in output in fourth-quarter 1979 and in 1980. Thus, actual wage settlements are likely to come in well below current demands, perhaps at close to the 14% figure of 1978. Settlements of this order would restore some market confidence in sterling, whose oil-based buoyancy will be highlighted as the December 19 OPEC meeting approaches.

Italian economic growth will slow dramatically in 1980.

Italy's inflation rate in the first eight months of 1979 was an annualized 17%, the result of continuing rapid monetary expansion—the narrowly-defined money stock in April was up 23% from the year-earlier level—and the latest round of oil price increases. For 1979 as a whole, official forecasts are for real GDP growth of over 4%, largely attributable to rapid real growth during the first quarter. In 1980, real growth is expected to decline sharply to 1.5%, assuming no change in current policies. The gloomy growth outlook, however, has prompted the new Government to propose a modestly reflationary budget for 1980 aimed at raising real growth to 2.5%. Personal tax allowances are to be increased and a $3.7-billion housing program will be instituted. Partially offsetting these stimulative measures will be hikes in public utility charges and higher property taxes. If these measures are enacted, Italy's 1980 public-sector borrowing requirement could rise to some 40 trillion lira from an estimated 36 trillion in 1979.

Norway's restrictive policies have produced solid results.

The stringent economic policies in place since early 1978 are generating better results than previously thought for the Norwegian economy. Aided by increased oil production, GDP has begun to grow rapidly, and the recent upturn in exports and investment expenditure may boost the 1979 growth rate to the 4% level. Despite more rapid growth, the trade deficit for the first eight months of 1979 narrowed to 2.43 billion kroner, versus kr. 3.31 billion for the comparable year-earlier period. The inflation rate remains slightly above 8%, with July wholesale prices up 8.2% and August's up 8.4%. The financial community expects the brisk pace of growth to continue well into 1980 with the year-on-year growth rate pushing 6%, despite further measures to curb bank lending announced in August. If the economy performs as well as is expected, Norway would be one of the few European countries to see a 1980 growth rate higher than in 1979.

Japanese foreign direct investment patterns have shifted.

Japan's foreign direct investment rose 64% to $4.6 billion in the fiscal year ending March 1979. The increased Japanese investment abroad went mostly to industrialized, primarily North American, countries and the Middle East. Until 1975, the bulk of Japanese overseas investment was in the manufacturing sectors of developing countries, mainly Asian, to exploit the availability of raw materials and cheap labor. Investment in the more advanced countries was limited to the non-manufacturing sectors associated with the promotion of Japanese exports. Since 1975, however, patterns of Japanese foreign direct investment have shifted, with the industrialized nations the recipients of heavy and growing Japanese

investment. Indeed, total Japanese investment in North America has now surpassed that of Asia, and the investment has been concentrated in the manufacturing sectors of the North American countries. Reasons for the shifts in Japanese overseas investment patterns include the marked expansion in the Japanese balance-of-payments surplus; the appreciation of the yen, which makes exports from Japan less competitive; an effort to assuage the criticism of the industrialized countries; and the desire to tap the sophisticated labor force of the industrialized world. The patterns are expected to be sustained with increased Japanese investment channeled to the industrialized countries, very probably at the expense of investment in lesser-developed areas.

Peru's economy on upswing, but inflation and weak investment persist.

Peruvian economic indicators for the first half of 1979 point to continued economic improvement. Real GDP is estimated to have risen more than 3% following several years of decline, while the budget deficit narrowed as the growth of revenues exceeded the growth of expenditures by nearly 35%. On the trade front, results are also positive. A cutback in imports, a resumption of oil exports, mineral price increases, and the positive impact of economic policies on non-traditional exports are expected to generate a trade surplus of over $1 billion this year, up from $340 million in 1978, and markedly better than the average annual deficit of more than $750 million posted in the 1975-1977 period. Still, the bright outlook is clouded by continuing high inflation—the annual average rate exceeds 60%—and sluggish private investment. While the authorities are combatting price increases by further tightening the growth of the monetary aggregates, restoration of private-sector confidence ultimately depends on sustained improvement in the country's economic development.

Foreign remittances play key role in South Yemen's economy.

Expatriate remittances are a mixed blessing for South Yemen's economy. While they enhance the country's balance-of-payments position, they swell domestic liquidity and create inflationary pressures. Remittances, derived mainly from Yemeni workers in Saudi Arabia and other Gulf States, have risen from an estimated $55.8 million in 1975 to $257.7 million in 1978. The consequent increase in foreign reserves has been the primary cause of the growth in the money supply, which averaged nearly 34% in the 1976-1978 period. The future development strategy will depend heavily on the return of skilled workers, but also on the continued receipt of foreign exchange. Thus, the increase in state expenditure forecast for the 1979-1983 development plan—74 million dinars per annum, versus 39 million annually in the previous plan—is designed to encourage South Yemenis to return home. And although the rate of increase in foreign remittances is officially forecast to decline from this year onward, such earnings still play a major role in the country's economy.

Tin prices high, with stockpile-release actions delayed.

World tin markets continue buffeted by the uncertain prospects for U.S. stockpile legislation. With tin consumption continuing to exceed production, tin prices remain well above the $6.82-ceiling established by the International Tin Council. The ceiling has been ineffective because the Council's buffer stock has had no tin available to sell, and legislation to release tin from the U.S. strategic stockpile—which currently contains an excess of 170,000 tons over requirements—has been delayed. As many as eleven bills were introduced in Congress in 1977 and 1978 that dealt directly with the issue of tin stockpile releases, but these have all bogged down in procedural difficulties. Currently, the Mollohan Bill, which has been passed by the House and will be taken up by the Senate this month, would release 35,000 tons, 5,000 of which would serve as the U.S. contribution to the ITC buffer stock. If this bill passes, significant downward pressure would be brought to bear on tin prices.

New Fed Strategy: Unanswered Questions

The Federal Reserve will place greater emphasis on the behavior of bank reserves and less emphasis on limiting short-run fluctuations in the Federal funds rate—at least during the next few months—according to the Fed's announcement on October 6. This shift of focus from the price of credit to the supply of money and credit has been proclaimed by many analysts, and indeed has the potential to be, the most significant monetary policy development in decades. There is still a great deal of uncertainty, however, over whether this announcement actually will be translated into a *major* shift in the Fed's conduct of monetary policy.

One unanswered question is how long this new operating strategy will remain in effect. In the Fed's announcement, it was noted that this change was adopted "to support the objective of containing growth in the monetary aggregates *over the remainder of this year* within the ranges previously adopted by the Federal Reserve." Thus, it is not clear whether this policy shift will continue into the 1980s.

The extent to which the Federal funds rate will be allowed to fluctuate in order to control the growth of bank reserves is also uncertain. While the Fed did say that wider fluctuations in the funds rate would be permitted, it also noted that there will still be constraints on the short-run volatility of the funds rate.

The Fed has also not yet specified *which* measure of reserves it plans to control. Chairman Volcker has indicated that movements in both total and nonborrowed member bank reserves, as well as in the monetary base, will be taken into account in determining policy. But the relative weights attaching to these different measures have not yet been revealed by the Fed.

Finally, the Fed has not disclosed what growth rate of bank reserves—however measured—is consistent with its targets for money (M_1 and M_2) growth. Indeed, it is likely that the Fed *does not know* with any great degree of accuracy what growth rate of reserves is necessary to achieve its desired money growth targets. Determination of this "desired" growth target for reserves has in fact been made more difficult by the imposition of marginal reserve requirements on banks' "managed liabilities" not included in M_1 or M_2 (such as Eurodollar deposits and repurchase agreements), a step which was part of the October 6 program.

All in all, it will probably take some months to accumulate much evidence on the degree to which the conduct of monetary policy will actually shift, or how such a policy change will be reflected in the tactics of open market operations. For now, the significant development is that the Fed has indicated a resolve to place more emphasis on controlling the supply of bank reserves.

Asia and Oceania — Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP in 1978		BALANCE				
		3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves in millions of dollars	12-month change	months of imports covered	
Asia										
Afghanistan	Land reform program and political unrest disrupt agricultural production.	June	− 3%	3.9	$ 215	July	405	+ 30%	12.3	
Bangladesh	Jute price floor set to encourage production, curtailed by drought last year.	Mar.	+47%	7.8	95	Aug.	408	+ 37%	3.1	
Burma	Real growth may reach 6% in FY 1979/80, reflecting excellent harvest.	June	+45%	4.3	135	Aug.	188	+ 29%	6.9	
China, People's Republic	Slower growth planned for 1979 to cool the economy.	June	+40%	445.0	450	Dec.	2,413	− 1%	2.2	
Hong Kong	Despite U.S. slowdown, export-led growth is maintained by aggressive marketing elsewhere.	July	+36%	13.3	2,904	n.a.	—	—	—	
India	Grain output may decrease 10% this year as a result of severe drought.	June	+ 3%	140.4	219	May	7,481	+ 22%	10.9	
Indonesia	Unexpected boom in primary commodities exports will boost GNP growth to 7% in 1979.	Mar.	+ 5%	44.6	319	Aug.	3,355	+ 35%	6.0	
Japan	Investment in new plant and equipment expected to rise 13% in FY 1979/80.	July	+ 7%	956.4	8,324	Aug.	25,475	− 14%	3.7	
Korea	Strong deflationary measures will slow growth to a more moderate 7%-8% this year.	June	+20%	46.0	1,242	July	2,594	+ 2%	2.1	
Malaysia	Strong exports and quickening investment pace point to healthy growth prospects.	May	+36%	14.7	1,140	June	3,763	+ 34%	7.6	
Pakistan	Wheat crop up 10% from last year; sugar and cotton production drop.	Jan.	+15%	17.0	218	July	323	− 60%	0.5	
Philippines	Energy squeeze and strong inflationary pressure sapping growth of economy.	May	+34%	23.7	511	July	2,145	+ 16%	4.8	
Singapore	Higher oil prices and utility charges likely to dampen industrial activity.	June	+32%	7.5	3,205	Apr.	5,366	+ 25%	5.0	
Sri Lanka	Lower agricultural output cuts annual GDP growth to 5% from 8% year-earlier.	Apr.	+ 8%	2.4	170	Aug.	453	+ 27%	5.8	
Taiwan	U.S. recession is affecting major exports and will moderate GNP growth to 7%-8% in 1979.	July	+15%	23.5	1,304	July	1,555	+ 3%	5.9	
Thailand	Satisfactory harvests and strong demand for exports help maintain growth at 7½%-8%.	June	+32%	20.5	452	July	2,246	+ 1%	4.7	
Oceania										
Australia	New anti-inflationary budget inspires business confidence; labor unrest remains key challenge.	Aug.	+27%	104.9	7,377	July	2,425	− 10%	1.4	
New Zealand	Slowdown in government spending expected to weaken growth prospects.	July	+31%	13.8	4,409	July	791	+ 3%	2.2	

Economy at a Crossroads

The Federal Reserve's latest discount rate hike and related actions further cloud the already uncertain U.S. growth outlook. With the economy buffeted by a gasoline shortage during the spring, real GNP fell at an annual rate of 2.4% in the second quarter. Many economists heralded this figure as evidence that the long-awaited recession had arrived. But with improved availability of gasoline, the business outlook brightened in the third quarter, and advance estimates show that the economy grew slightly. Unemployment dropped back to 5.8% in September, after rising to 6.0% in August from 5.7% in July. And inflation not only continued unabated, but showed some signs of acceleration, as consumer prices rose 1.2% in August and producer prices advanced 1.4% in September.

The new Fed actions are intended to help reduce inflation. But the initial effect will be a further slowing of the economy. So far, consumer spending for goods and housing has borne the brunt of the slowdown, and it is likely that these sectors will continue to deteriorate. Housing starts are already 11% below their year-ago levels and are expected to move considerably lower in the months ahead. Mortgage rates at 12% or higher will tend to choke off some demand for funds, and the combination of higher market rates and lower net funds inflows (with the specter of outflows) will reduce the supply. And even though interest rates on most other consumer loans have not risen, and are not likely to rise because of legal barriers, net extensions of consumer credit totaled only $2.5 billion in August (compared with an average of $3.5 billion per month in the first six months of the year) and are expected to slow further or contract, dampening consumer spending.

Businesses are likely to be affected more by the latest shift in monetary policy in the near term. Higher interest rates make the existing high level of inventories more burdensome. Unless sales pick up—an unlikely prospect—production cutbacks will spread outside the auto and other consumer durable industries. However, until inventories are aligned with sales, cash flow and profits will suffer. With less money available to spend, factories operating at lower rates of utilization, and borrowing costs increased, investment in plant and equipment is likely to fall.

There seems to be little doubt that the economy will slow in the coming months, but the severity and duration of weakness are by no means certain. In the first place, it is not yet clear how high interest rates will rise as a result of the current shift in Fed policy. Nor is it clear what the fiscal policy response will be to rising unemployment as the spring primary elections approach. A tax cut sometime next year is widely anticipated, but the magnitude and timing depend upon how quickly the economy deteriorates. And even if inflation drops below double-digit levels early next year, as the Government expects, it will still be uncomfortably high by historic standards.

F PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate	exchange rate in U.S. dollars		
of IMF it, mil- f dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	October 10, 1979		current monetary conditions	
0	Trade deficit expected to top $100 million in FY 1979/80.	n.a.	n.a.	Feb.	+ 83%	—	.0250	Interest rates raised to encourage deposits.	Afghanistan
18.0	Growing workers' remittances boost international reserves.	June	+14%	May	+ 17%	—	.0710	Tight credit conditions continue.	Bangladesh
30.9	High world market prices for teak boost export earnings.	June	+ 4%	n.a.	—	—	.1550	Credit expanded to cooperative and private sectors.	Burma
—	Rapid import growth to continue in 1979.	n.a.	—	—	—	—	.6650	Government agrees to borrow in yen from Japan Eximbank.	China, People's Republic
—	Strengthening Hong Kong dollar reducing cost pressure on exports.	July	+12%	June	+ 36%	—	.2035	High interest rates to be maintained.	Hong Kong
0	Rising oil prices widen trade deficit, despite export buoyancy.	June	+ 5%	May	+ 19%	9.00%	.1235	Interest rates raised in nonpriority sectors to curb inflation.	India
0	Strong export earnings will increase reserves beyond $4.5 billion by year-end.	July	+26%	Jan.	+ 40%	—	.001650	Credit still tight to combat inflation.	Indonesia
0	August current-account deficit of $1.5 billion vs. surplus year-earlier.	July	+ 4%	June	+ 12%	5.25%	.004440	Bank of Japan continues to curb commercial bank lending.	Japan
15.8	Rapid OPEC income growth to spill over into demand for Korean exports.	July	+18%	July	+ 37%	15.00%	.0022	Further credit tightening expected.	Korea
0	Prices of all major exports continue on uptrend.	July	+ 3%	May	+ 14%	—	.4630	Low interest rates maintained to spur investment.	Malaysia
33.0	Reserve level continues to decline as aid flow decreases.	July	+12%	May	+ 24%	10.00%	.1020	Credit conditions eased for exporters.	Pakistan
27.0	Narrow export base and weak foreign demand will hurt in coming months.	July	+21%	June	+ 27%	4.00%	.1365	Credit squeeze in effect to fight inflation.	Philippines
0	Electronics and petroleum products lead rapid export growth.	July	+ 3%	May	+ 19%	—	.4670	Prime rate expected to hit 10% by year-end.	Singapore
71.0	Oil import bill tops $500 million in first half.	July	+ 7%	May	+ 35%	10.00%	.0675	Credit tightened to control inflation.	Sri Lanka
0	Surge in metal/machinery exports offset by textile/electronics slowdown.	July	+11%	May	+ 41%	12.50%	.0290	Credit restrictive to curb inflation.	Taiwan
15.0	Government contemplating new measures to boost manufacturing exports.	June	+ 4%	Feb.	+ 35%	12.50%	.0510	Double-digit inflation prompting tight liquidity measures.	Thailand
21.0	Rising service payments exacerbate current-account deficit.	June	+ 9%	May	+ 13%	—	1.1230	Low budget deficit should ease pressure on interest rates.	Australia
17.0	Current-account deficit widening because of higher services payments.	June	+12%	Apr.	+ 26%	13.00%	.9955	Credit conditions remain tight to curb inflation.	New Zealand

World Interest Rates

market rates of October 10, 1979; bond yields as of October 5, 1979

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	13.00	14.00	10.00	9.50	5.00	12.00 penalty rate 15.00	8.00	1.00**	5.25
Day-to-Day Money	13.25 Oct. 11	14.00	13.50	12.00	11.50	8.40	12.50	9.625	0.375**	6.8125
Treasury Bills 91-day, Middle Rates	11.67	12.50	14.3125	13.00 120-day	n. a.	n. a.	10.60 82 day	no dealing	no market	5.125 2-month
Commercial Paper prime, 3-month, asked	12.75 finance paper	13.10 finance paper 15% tax w/h	12.66 H. P. on discount basis	9.90 Certified	12.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.50	13.00 15% tax w/h	14.00	12.00 Certified	not traded	7.40	13.25	no market	3.00** not traded	no market
Government Bonds Long-term, new and old issues, average yield	9.34	11.125	12.41	9.24 20% tax w/h	10.26	7.54	13.26	8.72	3.50**	7.56
Industrial Bonds prime, long-term, new and old issues, average yield	10.10 Aa Industrials	11.625	12.89	12.08 20% tax w/h	11.79	7.83	13.61	9.19	4.68**	6.95
Bank Short-Term Rate to Best Borrowers (prime rate)	14.50	13.75	15.00	13.50	10.10	7.25	15.50*	11.50	4.00**	5.50
Bank Time Deposits 3-month	12.875 Cert. of Dep.	12.85 Cert. of Dep.	14.00 Cert. of Dep.	12.25	12.125	8.20	8.50	10.625 large deposits	1.8125** residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	14.625	no market	14.125	no market	13.00	7.8125	no market	9.9375	2.375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8576	2.1685	.03420	.2380	.5597	.001209	.5046	.6194	.004428
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.25 *P*	.15 *P*	1.00 *P*	.85 *P*	6.45 *P*	2.00 *D*	4.45 *P*	12.30 *P*	7.20 *P*

Eurodollar Deposits
(London, interbank, bid)
October 11

7-day	14.25
1-month	14.8125
3-month	14.875
6-month	14.8125

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.60
U.S.-Canada Treasury Bills	−1.56
U.S.-Canada Finance Co. Paper	−1.42
Eurodollars-U.K. Local Auth. Deposits	+ .53

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.15
Over 7 yrs.	10.80
DM Bonds	
7 yrs. and under	7.50
Over 7 yrs.	7.75

Gold Price
London afternoon fixing
413.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Rate rises to 16.50 Oct. 15.

** Market rates as of Oct. 3; bond yields as of Sept. 28.

Structure and Growth of Latin American GDP: 1960-1978

	Structure		Average annual real growth						
	1960-64	1970-74	1961-65	1966-70	1971-74	1975	1976	1977	1978*
	(percent)					(percent)			
Primary Sector (agriculture, mining)	20.1	15.4	4.5	2.6	3.5	−0.7	2.3	5.0	2.3
Secondary Sector (manufacturing, construction, power, transportation, communications)	35.5	39.5	5.6	7.5	8.7	3.2	5.4	4.9	5.3
Tertiary Sector (commerce, financial and other services, government)	44.4	45.1	5.5	6.0	7.7	4.2	4.7	3.9	4.0
Gross Domestic Product	100.0	100.0	5.3	5.9	7.5	3.1	4.7	4.5	4.3

*Preliminary

Source: Inter-American Development Bank

Latin American Economic Outlook

The economic outlook for the Latin American and Caribbean region is for moderate growth over the next several years as it, together with the world economy, adjusts to the problems of inflation and higher oil prices. Real GDP growth for the Latin American region was 4.3% in 1978, down from the 4.5% rate of 1977. The slight deceleration was due to a recession in Argentina and output or growth declines in Peru, Nicaragua, Jamaica, Chile, Venezuela, and Costa Rica. The major growth advances in 1978 were recorded by Brazil, Mexico, and Colombia. This year, further regional growth slowdown is anticipated, with a projected GDP growth rate of about 4%.

Although these growth rates are higher than the 1%-2% forecast for the United States and other major industrial countries for this period, the Latin American countries have sustained significantly higher growth rates in the past. From 1970 to 1974, for example, prior to the quadrupling of OPEC prices, Latin American growth averaged 7% per annum.

The recession and high inflation in the United States and other major economies is a serious concern for Latin America; it could translate into both slower demand for Latin American exports and higher import prices. Manufactured exports are particularly sensitive to world demand conditions; this could hit Brazil—which is expected to see its current-account deficit widen from $5.9 billion in 1978 to $9 billion this year—especially hard. Mexico and Argentina, however, should take up some of the slack with strong output advances. Venezuela and Ecuador, on the other hand, are likely to slow somewhat in response to policies of restraint, while Chile and Colombia should maintain respectable 6% growth rates. For Central America, the severe economic disruption in Nicaragua has resulted in a large output decline for that country and slower growth for the entire region. In the Caribbean, the oil-producing economy of Trinidad and Tobago is constrained by public-spending restrictions aimed at maintaining more orderly development, while Jamaica and the Dominican Republic are pursuing restrictive fiscal and monetary policies to curb inflation, debt, and correct payments imbalances. (In the Dominican Republic, the added burden of repairing hurricane damage further constrains economic expansion.) For the remaining countries in the region, the need to combat inflationary tensions at a time of slower world economic growth will lead to subdued output gains in both 1979 and 1980.

Inflation has been a perennial problem in Latin America, and there are few signs that it will abate any time soon. Average prices rose 40% for the region as a whole in 1978, propelled by rates of 176% and 39% in Argentina and Brazil. Mexico did succeed in paring its inflation rate to 18%, and the rate of Chilean price increases was cut from 92% to 40% between 1977 and 1978. But in such countries as Peru and Jamaica, prices nearly doubled and tripled from 1977 to 1978. Through the first nine months of 1979, inflationary pressures remained a concern for all of the major Latin economies. Brazil is currently struggling with a 50% rate; Argentina's price rises are surging at about 160%; Mexico is trying to cut its inflation rate below 18%; and Chile seems to have reached a lower limit of 30% price increases. For these and other countries in the region, inflationary pressures demand constant vigilance and adoption of traditional macroeconomic policies of restraint and slowdown. While a favorable inflation prognosis cannot be confidently predicted for the Latin American region over the next one or two years, all of the countries in the region are highly sensitive to the problem and are all formulating policies to moderate price pressures. One such policy is import liberalization, which seeks to increase the available supply of domestic goods and thereby reduce the overall rate of price increases.

Balance-of-payments trends

The Latin American region posted a $14.5-billion aggregate current-account deficit in 1978, $3.5 billion higher than in 1977. A major source of the widening deficit was the unprecedented $4.4-billion current-account deficit in Venezuela, whose oil export earnings were overtaken by strong import demands. Argentina's payments balance was healthy—posting a current-account surplus of more than $2 billion—reflecting both weak import demand and strong agricultural exports. Brazil and Mexico both ran large current-account deficits in 1978, though they were easily financed by international capital flows. The expectation for 1979 is for an increase in the Latin American aggregate current-account shortfall to $16 billion, primarily because of a larger (oil-induced) deficit in Brazil and continuation of a $2.5-billion deficit in Mexico. By 1980, however, the aggregate Latin American current-account gap is expected to begin declining as Venezuela's trade account shifts into large surplus as a result of higher OPEC prices, and as Brazil realizes gains under its import replacement projects—while at the same time sustaining its export momentum. The more optimistic balance-of-payments outlook for the region, however, presupposes only a moderate world economic slowdown.

The larger balance-of-payments deficits of recent years have meant an increase in the overall inter-

national debt of the Latin American region. For individual countries such as Brazil and Mexico, the outstanding debt is sizable in total terms and the pressure of servicing this debt puts a substantial demand on export and services earnings. In most cases, however, the debt is being channeled productively for long-term investments. And although the aggregate debt may continue to rise for a few more years, many countries in the region are reaching the point where their export earnings will be sufficient to begin reducing their overall external debt exposure.

Import liberalization policies and the growth of manufactured exports are two important economic developments that have evolved in the last several years in Latin America. The trend toward freer imports has been led by the countries of the Southern Cone—Argentina, Chile, Brazil, and Uruguay—which have taken bold steps to trim tariffs and phase out other import barriers.

On the export side, the position of manufactured goods exports has strengthened considerably; such exports now account for 20% of the Latin American total. For Brazil and Mexico, as well as other important Latin American exporters of manufactures, there are considerable benefits in the form of both additional foreign exchange and diversification of exports plus higher investment, productivity, and real incomes. The growth of manufactures, however, has not necessarily meant the decline of basic commodities exports. Indeed, almost without exception, every country has begun to redirect investment toward agriculture, both for domestic needs and for export.

The growth of the petroleum sector has been another major factor of importance, affecting foreign trade and the economies of a number of Latin American and Caribbean countries. Mexico is a well-publicized case in point. But the region also includes two members of OPEC—Venezuela and Ecuador—and another net oil exporter, Trinidad and Tobago. Peru has also achieved oil self-sufficiency, while Argentina is close to it. And Paraguay is destined to become the world's largest electricity exporter in a few years when the massive Itaipu hydroelectric project is completed. Among the major economies, Brazil is the most affected by its need to import large quantities of oil; it is currently making substantial efforts to increase the proportion of gasoline produced from sugar cane and to augment hydroelectric generation.

Status of economic integration efforts

The arguments for greater economic integration of the Latin American region have generally centered on the benefits of larger-scale manufacturing and economic activities, greater competition, removal of trade restrictions, and some evolution towards greater political cooperation. But progress toward integration has been slow or even negative. The conflict in Nicaragua, in particular, has dealt a serious blow to trade in the Central American Common Market (CACM). The Andean Common Market (ANCOM) has made slow progress in trade liberalization, although considerable steps have been taken in the industrial location plans of the member countries. And in the oldest of the integration efforts, the Latin American Free Trade Association (LAFTA), progress toward the goal of a common market by the end of 1980 has all but been abandoned. The organization has had great difficulties in agreeing on trade barrier reductions and economic integration among its members. More promising smaller-scale economic integration efforts, however, are being made among the members of the River Plate Basin Group (Brazil, Argentina, Bolivia, Paraguay, and Uruguay) and among the Caribbean countries in the Caribbean Group for Cooperation in Economic Development.

Political and social evolution

Over the past year, the most notable political changes in the Latin American and Caribbean region have been the several shifts from military to civilian governments. The most complete break occurred in Ecuador, where a free election has produced a civilian president for the first time in eleven years. And the military governments in Peru and Bolivia have either indicated an interest in, or already taken concrete steps toward, more democratically-elected regimes. Last year, a free and open election was held in the Dominican Republic and a more liberal government emerged. In Nicaragua, a revolutionary guerrilla movement has succeeded in toppling a decades-old dictatorship and replacing it with a more broadly representative junta. Among the major countries, Argentina, Brazil, and Chile continue under military rule, but to varying degrees, each of these governments has indicated possible timetables to pave the way toward openly-elected regimes. Although difficult to characterize for such a heterogeneous region, it seems that political evolution over the next several years will be toward more openly-contested political administrations, along the lines of the pluralistic systems in Venezuela, Colombia, Costa Rica, and Mexico. For all of the countries, military and civilian alike, the major social challenge ahead is the achievement of better conditions for an estimated 30% of the 340 million Latin Americans that still lack some of the essential elements for human well-being.

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